# Topline Revenue

Why Focus on Pricing?

integrated insight inc.

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Successful businesses know they cannot cut their way to profitability. Focusing on revenue will help alleviate some of the cost pain. In addition to driving more demand, consider rate improvement which can be equally, if not more impactful. On the flip side, decreasing price or even holding on price to try and retain or capture more market share is a risky proposition. Let's examine both.

***The power of pricing***

It is often said that a 1% increase in price realization equates to a 5% to 10% improvement in net income, depending on a company's cost structure. That certainly gets your attention, but exactly how does it work? The reason pricing can be so impactful is that is has little overhead cost associated with execution, and for many products and services, little price-elasticity experienced within reasonable price changes.

Consider the following example. Joe's Cigars offers a variety of imported cigars, and on average they sell at about a 50% markup for total revenue of $50,000 per month. In addition to cost of goods sold, Joe incurs about $10,000 a month in operating expenses, mainly the rent on his store, salaries, supplies, etc. leading to a monthly profit margin of about 13%. For the purpose of illustration, assume Joe takes an across the board 1% price hike. *Note: This may not be the best strategy to deploy given some products likely sell better than others and different consumers may spark to different products.* With all costs remaining the same, and assuming no loss in demand from the price increase, the additional $500 in monthly revenue flows straight through to net income, increasing by 7.5% for the month.

So why not raise the price by 2%, 3% or 10%? Your business might very well be able to absorb higher increases with little or no penalty, but before ingesting the pricing drug, consider that a long term, sustainable pricing strategy is really what you want to achieve. Leading with the consumer and their specific wants and needs will likely result in even higher profits. Seldom is price gouging a long-term strategy. The point is that there is power in pricing and developing this discipline is well worth the investment.

***Why holding on price over the long term is a bad idea***

Some small businesses are shy about taking price increases. More than once I've received the letter of apology from a provider, stating that they haven't taken a price increase in several years, but now need to pass on some of the cost of doing business to their customers. Arguably, passing those costs on with an annual price increase is less painful for both the company and consumers. As a consumer, I really haven't given you credit for *not* raising price – in fact, it wasn't even a fleeting thought – but now I find myself reacting to a rather strong increase I wasn't expecting – an unwanted surprise.

| | Current | With 1% Price Increase | Change |
|---|---|---|---|
| Total revenue | $50,000 | $50,500 | 1.0% |
| Cost of goods sold at 50% markup | ($33,333) | ($33,333) | |
| Gross margin | $16,667 | $17,167 | 3.0% |
| | | | |
| Monthly operating expense | ($10,000) | ($10,000) | |
| Monthly net income | $6,667 | $7,167 | 7.5% |
| Profit margin | 13.3% | 14.2% | |

But neither is it an appealing option from the company's perspective. Let's say that to achieve his $50,000 in monthly revenue Joe sells 2,500 cigars at $20 each. Consider that costs of goods sold and operating expenses are both likely increasing annually at the rate of inflation, and for illustration, let's say inflation has averaged 2% per year. After four years of inflation and no price increase, Joe loses over half his monthly income - $3,572 – unless he realizes stronger sales. Joe would need to sell 1.8% more cigars each year, or a little over 7% more for the four years combined, just to break even.

If demand is rising, it is easy to ignore pricing, or go without a price increase, because revenue is still growing at a healthy rate. But often times, businesses fail to consider the reason behind their changes in demand. Have more customers moved to the area? Did a competitor go out of business? Did your own product improvements drive demand? Or, are customers flocking to your business because they know you are holding your prices. That last one is a stretch. Revenue growth shouldn't be an *"or/else"*, meaning drive volume or rate, but not both. It can and should be a *"both/and"*. Drive demand, but take price as well.

| | Five Years Ago | Today | Change |
|---|---|---|---|
| Total revenue | $50,000 | $50,000 | No change |
| Cost of goods sold at 50% markup | ($33,333) | ($36,081) | 2% annually for four years |
| Gross margin | $16,667 | $13,919 | (16.5%) |
| | | | |
| Monthly operating expense | ($10,000) | ($10,824) | 2% annually for four years |
| Monthly net income | $6,667 | $3,095 | (53.6%) |
| Profit margin | 13.3% | 6.2% | |

***And if holding price is a bad idea, dropping price is worse!***
Demand is waning and desperation sets in. Sooner or later, someone calls the question: "Should we lower our price?" Reducing price as part of a promotional offer, coupled with the necessary sales and marketing support, can often help stimulate demand in the short-term. (For more on promotions, see "Promotional Pricing".) But seldom does a permanent, non-offer driven reduction work unless price was truly the issue for lack of demand in the first place. Therefore, the first step should be research to understand why demand is waning and address the true cause.

| | Current | With 5% Price Decrease | Change |
|---|---|---|---|
| Total revenue | $50,000 | $47,500 | -5.0% |
| Cost of goods sold at 50% markup | ($33,333) | ($33,333) | |
| Gross margin | $16,667 | $14,167 | -15.0% |
| | | | |
| Monthly operating expense | ($10,000) | ($10,000) | |
| Monthly net income | $6,667 | $4,167 | -37.5% |
| Profit margin | 13.3% | 8.8% | |

The second step is to understand the impact of a price reduction – what do you have to believe will happen to make it pay off? Consider Joe's Cigars once again. While the upside to pricing can be powerful, the downside can be risky and brutal if your assumption that a price reduction will permanently increase demand is wrong. If Joe takes a 5% reduction – arguably too little to catch consumer attention – he immediately loses over a third of his profit unless new demand materializes. In fact, Joe needs to see a 5% increase in sales just to break even. But why take the risk for a break-even proposition? More likely, Joe is looking for an 8%-10% increase in sales from his 5% reduction.

Now consider how consumers might respond to the price reduction. You'll likely announce the reduction once and in a low key fashion. Some consumers may hear the message, others not. Taking a price reduction does not carry the same sense of urgency, "deal of the century" message that a promotional offer can achieve. And what research have you done that shows a 5% price reduction will be motivating? If demand has fallen for another reason, it likely will not. If price is really the issue, how much of a gap exists in the consumer's mind? The true target reduction may be much higher than 5%, increasing your risk dramatically.

Rather than across the board price reductions, consider more holistic pricing strategies that price where consumer's place value, and are structured to respond to specific wants and needs.

**Who we are:** Integrated Insight, Inc. is an Orlando, FL based analytics consulting firm, helping organizations out-behave the competition. The company was founded by two former Disney executives with a passion for helping organizations and the people in them reach their full potential. The company specializes in the use of data-driven insights and robust analytics to pinpoint untapped opportunities and ensure long-term, sustainable growth in three primary capacities: New Business Strategy, Business Optimization, and Research and Consumer Insights.

For more info visit www.integratedinsight.com. For immediate help contact Joni Newkirk at 352-988-3490 or jnewkirk@integratedinsight.com